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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
DOCKETED
SEP 26 2007
DOCKETED BY

COMMISSIONERS

MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

In the matter of the securities offering by: Reserve Oil & Gas, Inc., a Nevada Corporation 3507 N. Central Avenue, Suite 503 Phoenix, AZ 85012 Allen and Jane Doe Stout, Sr. Husband and wife 1309 West Portland Street Phoenix, AZ 85007-2102 Allen and Jane Doe Stout, Jr., husband and wife 1309 West Portland Street Phoenix, AZ 85007-2102 Respondents.	DOCKET NO. S-20437A-05-0925 **POST HEARING MEMORANDUM**

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AZ CORP COMMISSION
DOCKET CONTROL

Respondents Allen Stout Sr. (aka Allen C. Stout "Stout") and Reserve Oil & Gas, Inc. sold unregistered securities from Arizona. Offers were publicly made via the internet for oil and gas in Reserve Oil & Gas ("ROG") and those offers contained tax advice concerning the investments. The public offers failed to inform potential investors that Stout, the named President of ROG was convicted of tax evasion, something a reasonable investor would have wanted to know. Further, the website stated that "Reserve has entered into an agreement with Benco/Rife operating, to help develop their six thousand plus acres." No such agreement exists.

At hearing, the Securities Division (the "Division") proved at least eight. additional securities violations that include: sales of, offer to buy, or offers to sell securities by ROG and Stout. Fraud was also proven in connection with these transactions. One fraudulent activity

concerned an investor who was not advised that a significant percentage of his investment was not invested in oil and gas. This was accomplished by providing him a false statement of the costs on the project. In another sale, the investor was not told that his money was in a "very high risk undertaking" as disclosed by the oil well operator. Instead, the agreement he signed simply stated "Specializing in Low Risk Opportunities" at the bottom of each page of the contract.

Additionally, Stout acted as an unregistered salesman of securities. Stout's activities were not exempt from regulation. These activities and those discussed below are based upon evidence admitted at the hearing and they prove Respondents violated the Arizona Securities Act (the "Act") A.R.S. § 44-1801 et seq.

I.

Preliminary Issues

A. Parties and Procedural History

On December 30, 2005 the Division filed a Temporary Order to Cease and Desist and Notice of Opportunity for Hearing (the "TC&D"). The TC&D alleged violations of the Act by ROG, Stout, Allen Stout Jr. (aka Allen L. Stout, "Allen L"), (collectively "Respondents"). Respondents' spouses were joined for the purpose of determining the liability of the marital community. Respondent Stout filed answers in which he admits he is married to Eugenia Stout. (*See* Exhibit S-27(b) at ¶ 1 and Amended Answer of Respondent Stout filed on February 27, 2007 at ¶ 5). Allen L. denies being married in his response and the Division does not contest his response to this allegation. (*See* Exhibit S-27(c) at ¶ 4). A hearing was conducted on the following dates: May 2 -3, 2007 and July 17, 2007.

B. Personal Jurisdiction

ROG's offering documents and sales contracts reveal ROG was located in and doing business from Arizona. (*See*, S-23 @ page ACC000296; See also, S-42(a), S-42(b), S-45, S-53, S-

54, S-56, and S-58). ROG's response in this matter admitted that while it was incorporated in Nevada, it was authorized to conduct business in Arizona and had a last know business address in Phoenix, Arizona. (*See* Response of ROG filed in this proceeding). Further, Stout and Allen L. admitted they resided in Arizona in their responses to these proceedings. In fact, at least since June 9, 2003 the business records of Wells Fargo identify Stout as the President and Secretary of ROG. (*See* S-23 ACC000296 to ACC000298). Every named Respondent filed an answer and no Respondent contested personal jurisdiction. The filing of an answer is uncontrovertable evidence of the parties intention to submit to the jurisdiction of the court.

C. Subject Matter Jurisdiction

The Arizona Securities Act (the "Act") A.R.S. § 44-1801 *et seq.*, prohibits: 1) the sale or offer for sale Arizona of unregistered securities, A R.S. § 44-1841; 2) committing fraud in the purchase or sale of securities, A R.S. § 44-1991; and 3) acting as an unregistered dealer or salesman of securities, A R.S. § 44-1842. All of these activities are prohibited "within or from" Arizona. Thus, as an initial matter the activities must be shown to be "within or from" Arizona for there to be subject matter jurisdiction.

The hearing record identifies investor payments being deposited into a Wells Fargo Bank account in Arizona and contains contracts between ROG from Arizona with out-of-state investors. (*See* S-42(a), S-42(b), S-45, S-53, S-54, and S-56). Finally, the website also directly connects Stout's and ROG's activities to Arizona. (*See* S-58). Consequently, the activities were "within or from" Arizona.

II.

SECURITIES & UNREGISTERED ACTIVITIES

The evidence shows that from October of 2004 through February of 2006, Stout and ROG ("Respondents") offered or sold securities, including ROG's oil and gas program, to investors (*See*

Exhibits S-36, S-37, S-40. S-42, S-43, S-44, S-45, S-46, S-49, S-50, S-56, S-57, and S-58). ROG received total proceeds of $225,000 from investors (*See* Exhibits S-42, S-46, S-49, S-50, and S-57). Respondents sold unregistered securities in violation of A.R.S. § 44 -1841, and acted as securities dealers and salesmen while not registered, in violation of A.R.S. § 44-1842.

A. ROG's Oil & Gas Program is an unregistered Security

The definition of "security" includes investment contracts. A.R.S. § 44-1801(23). ROG's drilling program meets the definition of an investment contract as set forth in *S.E.C. v. WJ. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946). According to *Howey,* a transaction is an investment contract when the transaction involves: a) an investment of money; b) in a common enterprise; and c) with the expectation of profits solely from the efforts of others.[1] ROG's oil and gas program meets these elements.

Concerning the first prong, investors placed their money in ROG. (*See* Exhibits S-42, S-46, S-49, S-50, and S-57). "Two tests have been developed to determine the existence of a common enterprise in order to satisfy the second prong of the *Howey* test: (1) the horizontal commonality test and (2) the vertical commonality test." *Daggert v. Jackie Fine Arts, Inc.,* 152 Ariz. 559, 565, 733 P.2d 1142 (App. 1986). Arizona courts have held that commonality will be satisfied if *either* horizontal or vertical commonality can be shown. *Id.* at 566. For vertical commonality to be established, only a positive correlation between the potential profits of the investor and the potential profits of the promoter need to be demonstrated. *Id.* at 566. Horizontal commonality requires a pooling of investor funds collectively managed by a promoter or third party. *Id.* at 565.

Here, ROG represented they had "an agreement with Benco/Rife Operating, Inc. to help develop their six thousand plus acres. Under the agreement, Reserve will raise $1,125,000 per well for a 75% working interest." (*See* S-38 page ACC000010) The pooling of funds is reflected in the participation agreements which assign a percentage of the working interest in a well to investors.

[1] The *Howey* case originally used the phrase "solely from the efforts of others;" however, this language was later modified to "substantially" in *SEC v. Glenn W. Turner Ent.*, 474 F.2d 476, 482 (9th Cir. 1973).

(*See* S-45 and S-56). In the offering materials it states that a third party will oversee the "drilling, completion and operation of the wells." (*See* S-38 ACC000010). Consequently, there is horizontal commonality as the investors' funds are pooled together and managed by ROG who proclaims to be "widely experience in oil and gas field operations." (*See* S-38 ACC000012). The second prong of *Howey* is satisfied.

For the final prong of *Howey* in Arizona, one must only establish that the efforts made by persons other than the investors were the undeniably significant ones, and were those essential managerial efforts that affected the failure or success of the enterprise. *Nutek Information Systems, Inc. v. Arizona Corporation Commission*, 194 Ariz. 104, 108, 977 P.2d 826 (App. 1998). In this case, the evidence clearly shows that the investors had no role in the success of the business. Investors do not select the wells. (*See* 36(c) @10:10 to 36:13). "Drilling for oil today is a complex, scientific process…" (*See* S-37 @ p. 8). According to the offering materials, "Officers of Reserve Oil & Gas, Inc. are widely experienced in oil and gas field operations." (*See* S-58 @ ACC000012). Investors do not select the wells or oversee the drilling, completion and operation of the wells. (*Id.* @ ACC000010). The success in the business clearly rests on the efforts of Respondents. The final Howey prong is thus satisfied and ROG's oil and gas program is a security in the form of an investment contract.

Finally, ROG's oil and gas program was not registered . (*See* S-2(a)).

B. <u>Rentech shares are securities.</u>

At the hearing, evidence was admitted concerning Mr. McKnelly ("McKnelly"). (*See* S-41 @ 6:12 to 7:25, 7:21 to 9:11, 10:11 to 11:19, 96:9 to 97:23, 100:7 to 103:7, 106:22 to 107:8,108:1 to 108:18, *See* also S-42, S-43, and S-44). Responding to questions posed to him at deposition by *Respondents' counsel*, and as was read and admitted at the proceeding, former investigator for the Division, Bill Smith ("Smith") testified as follows:[2]

[2] The Administrative Procedures Act (the "APA") A.R.S. §§ 41-1001 to 1092.12, does not mandate the exclusion of hearsay testimony, it specifically allows it. A.R.S. § 41-1062(A)(1). *See also* A.R.S. § 44-1973(B) and A.A.C. R14-3-

Q (By Mr. Gardner) I believe we were discussing Mr. McKnelly. And you indicated you had, you believe, two conversations with him in connection with his contact with respondents; is that right?

A. Correct.

Q. And in those conversations, you discussed a purported investment that Mr. McKnelly made with the respondents; is that right?

A. Correct.

Q. And what did he tell you about this?

A. Basically that he ran across Reserve Oil & Gas's website, visited it. Called or contacted Mr. Stout, asked for some information. Went through it. Wasn't real comfortable with his knowledge of investing in gas and oil. Called him back, said, 'I'm not interested' Mr. Stout called him back, said, 'Hey, I've got a good deal on some Rentech shares. Are you interested?"

Q. At that time, did Mr. McKnelly take those shares, or how did it proceed?

A. He sent Mr. Stout the check, and never received any shares. He had questioned Mr. Stout several times on why not. And there was always some problem, the attorneys were working on it, they'd get back to him. And it just never transpired.

(*See* S-41 at 100:7 to 101:7. *See also* Transcript of the proceeding Vol. I @ 147: 24 to 149:2).

Ariz. Rev. Stat. 44-1801(26) provides, in part, that a "security" is defined to include any "stock" to fall within regulation under the Act. The Division argues that Stout's[3] offer in Rentech shares to McKnelly is a securities transaction because it involves stocks. Indeed, according to McKnelly, "Initial payment to Reserve Oil and Gas, in the amount of $40,000 dollars, was for a purchase in equity, specifically common stock in Rentek (RTK) corporation." (*See* S-44 @ page ACC001828; *See also,* S-42(a), and S-41 @ 100:13 to 101:19). For this single transaction only,

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109(K). *See also* the Securities Division's Response to Respondents' Motion to Preclude Hearsay filed in this matter incorporated herein by this reference.

the Division does not claim that an *unregistered* security was involved. The Division requests that this tribunal take judicial notice of the fact that Rentech shares are registered with the S.E.C. and are traded on the open market under the symbol "RTK". Nonetheless, this conduct shows Stout acting as an unregistered salesman of securities and this violates A.R.S. § 44-1842.

C. <u>The Promissory Note Presented to McKnelly is a Security</u>

As presented at the hearing and discussed above, McKnelly forwarded $40,000 to Stout for Rentech shares. (*See* S-42(a)). At the proceedings, a document entitled "Promissory Note" was admitted into evidence. (*See* S-43 aka SD-2). Smith testified about the promissory note as follows:

> Q. (By Mr. Gardner) Did you discuss the promissory note with Mr. McKnelly?
>
> A. I did.
>
> Q. Okay. And what did he tell you about the promissory note?
>
> A. He told me that he had received a call from Mr. Stout asking him if he would be interested in a promissory note for the $40,000 that he had originally sent him for the Rentech shares. And Mr. McKnelly said, "Send it. I'll take a look." The first thing he was really concerned about was the date on it, which was dated back to the original check.
>
> Q. Okay.
>
> A. And that was a concern of his. And, also, the fact that at any point, at Mr. Stout's discretion, this promissory note could roll over into oil and gas.

(See S-41 @ 102:14 to 103:1).

On or about February 26, 2006 McKnelly communicated with Stout and ROG concerning this promissory note. (*See* S-44 @ ACC001828). The first sentence of McKnelly's letter states, "Sorry for the delay in replying to your email. I have read over your offer of a promissory note." *Id.* Remarkably, the promissory note which was admitted into evidence as S-43 specifically provides that

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[3] Investigator Smith testified that Mr. McKnelly's reference to Stout was to Allen C. Stout ("Stout"). *See* S-41 at

if the debtor fails to make payment of principal or interest, the debtor has the option to "have the principle [sic] and interest on [sic] note on any unpaid balance *applied towards a participation in an oil and/or gas well.*" (emphasis added). In other words, if McKnelly accepted the terms of the note he would have agreed to have Stout,[4] President, decide, *at his discretion*, to pay McKnelly back his money or have it placed in a participation in an oil and/or gas well! The promissory note is an offer to invest in the same oil and gas securities that constitute a security in the form of an investment contract as discussed *supra.*

D. Unregistered salesmen

Neither Stout nor Allen L. were registered security dealers or salesman. (*See* S-2(b) and S-2(c)). Therefore, securities offered or sold by either one of these individuals in Arizona is prohibited by law whether the security is registered or not. A.R.S. § 44-1842.

III.

OFFERS OR SALES, & FRAUD

A.R.S. § 44-1801(19) defines sale or sell as "a sale or any other disposition of a security or interest in a security for value, and includes a contract to make such sale or disposition." "Offer to sell" and "offer for sale" are defined in A.R.S. § 44-1801(13) as including "an attempt or offer to dispose of, or solicitation of an order or offer to buy, a security or interest in a security for value." These definitions apply where the transactions involve securities, as discussed above "security" includes stock and investment contracts. A.R.S. § 44-1801(23).

106:22 to 107:8.

[4] Although there are various references to Mr. Stout in the proceedings, there is ample evidence to prove that Allen C. Stout was President of ROG at the time of the complained of events. See bank records for Reserve Oil and Gas dated June 9, 2003 identifying Allen C. Stout as President of ROG. *See* S-23 @ page ACC000296 to ACC000298; *See also*, S-60 @ 33:3 to 34:3. Moreover, McKnelly identified his dealings had been with Allen C. Stout. *See* footnote 2.

Furthermore, fraud in connection with an "offer to sell or buy" or the "sale of purchase of securities" violates A.R.S. § 44-1991. Specifically included as fraud are untrue statements of material fact and omissions. *Id.* As it relates to fraud, the standard of materiality of omitted facts is whether a reasonable investor would have wanted to know. *Rose v. Dobras*, 128 Ariz. 209, 214, 624 P.2d 887, 892 (1981).

A. Offers & Sale to Darryl McKnelly

1. Offers/Sale Pre-TC&D

McKnelly informed Smith that he had come upon ROG's website, but after discussing the matter further with Stout (*See* footnote 2 supra), he decided not to invest because he was not 'comfortable' with his knowledge of oil and gas. (*See* S-41 at 100:7 to 101:7. *See also* Transcript of the proceeding Vol. I at 147: 24 to 149:2 and S-41 106:22 to 107:8). This took place in about October of 2004. (*See* S-44 @ page ACC001827). McKnelly was offered oil and gas securities, although he stated that "At no time did I show any intention to invest in an oil and gas well and no specific contract was presented to me for purchasing an interest in oil well." *Id.* It is not necessary for a contract to be presented for there to be an offer because an offer includes "an attempt or offer to dispose of, or solicitation of an order." A.R.S. § 44-1801(13).

The hearing record is clear. McKnelly viewed ROG's website, learned of the oil well securities, and simply decided not to invest. *(See* printout of ROG's website at S-58). Therefore, there was an offer of an unregistered security via the website to McKnelly in oil and gas investment contracts. McKnelly's lack of interest in investing is not legally relevant.

Upon declining the offer, Allen C. Stout ("Stout") offered McKnelly Rentech shares instead. (See S-44 @ page ACC001827; *See also,* Section II. B. *supra*). McKnelly stated in a letter he wrote to Stout, and forwarded to Smith, that his "initial payment to Reserve Oil and Gas,

in the amount of $40,000 dollars, was for a purchase in equity, specifically common stock in Rentek (RTK) corporation." (*See* S-44 page ACC001828; *See also,* S-42(a), S-41 @ 100:13 to 101:19). Notably Mr. McKnelly's check indicates "FOR RENTECH SHARES" in the memo. (*See* S-42(a), aka exhibit SD-1[5] to the Deposition of Bill Smith; *See* also S-42(b)). The date on the check is November 25, 2004. (*See* S-42(a), aka exhibit SD-1). According to the copy of the check provided by Wells Fargo Bank, this check was processed on December 3, 2004 and hence the offer to buy securities in the form of Rentek shares occurred before the TC&D issued. (*See* S-42(b)).

2. Offer Post- TC&D

The promissory note forwarded to McKnelly by Stout and ROG is an offer in the same oil and gas wells securities that are the subject of this case. (*See* S-43 aka SD-2). The offer was in about February of 2006, after the TC&D issued. (*See*, S-44 @ page ACC001828 aka SD-3). Furthermore, the letter from McKnelly to Stout and ROG explained that, among other reasons, McKnelly refused to agree to the terms of the note because, "The option that any unpaid balance could be applied to an interest in an oil or gas well is impossible to evaluate monetarily and is contingent upon events yet to take place and at unspecified terms." (*See* S-44 @ page ACC001828).

Respondents admitted an exhibit entitled "Receipt of Payment" which purports to be repayment on the promissory note by McKnelly, and it appears to contradict the correspondence McKnelly provided to Investigator Smith. (See R-1 and S-44 @ page ACC001828). McKnelly clearly communicated his refusal to sign the promissory note, why would he sign a "receipt of payment" concerning the same note? However, the two facts can be reconciled. McKnelly may have

[5] References to exhibits that use "SD" preceding the number are to exhibits that were introduced at the deposition of Investigator Bill Smith.

been willing to sign a receipt of payment for a promissory note he had refused to execute, because McKnelly may have done so in order to get his money back. While the "receipt of payment" may evidence repayment, [6] it does not negate the offer of securities made via the promissory note. If Respondents' position is that McKnelly did accept the note, it is evidence that he accepted Stout's offer to place his money in oil and gas securities at Stout's discretion.

3. Fraud in connection with Offers/Sales to McKnelly

The first offer to McKnelly in October of 2004 was from the internet site maintained by ROG and it related to oil and gas securities. (*See* S-41 at 100:7 to 101:7. *See also* Hearing Transcript Vol. I @ 147: 24 to 149:2 and S-41 106:22 to 107:8; *See also* S-44 @ page ACC001827).

In this particular case, oil and gas securities were touted as having particular tax advantages. (*See* S-58). The first page of the printout of this website stated "80% write-off of intangible costs plus depletion, and depreciation are tax benefits." Stout pled guilty to tax evasion under 26 U.S.C. § 7201 on February 14, 1997. (*See* S-3). Smith specifically inquired whether McKnelly knew of Stout's tax evasion conviction and testified that McKnelly indicated he did not know. (*See* SD -41 @108:1 to 108:15). The Division contends that a reasonable investor would have wanted to know of the tax evasion conviction because ROG touted the tax benefits of the oil and gas securities they offered.

The information is material. *S.E.C. v. Enterprises Solutions, Inc.,* 142 F. Supp. 2d 561 (S.D.N.Y. 2001). (Failure to disclose involvement in management of individual with criminal record and regulatory violations is violation of securities laws). Respondents' counsel has attempted to argue that there is a time limit on disclosure of convictions and introduced

[6] However, since McKnelly failed to cooperate and testify at the hearing, there is no foundation for McKnelly's signature on the purported "receipt of payment" document.

Regulations-K from the S.E.C. to make his argument. (*See* R-6). However, those regulations only apply to registration statements registered with the S.E.C. (*Id.* @ p. 3). ROG has not registered with the S.E.C. and therefore, the time limit concerning disclosures is inapplicable. Moreover, Arizona case law and statutes which govern this proceeding do not impose a time limit on the disclosure or omission of material facts. The standard is simply put, what a reasonable investor would want to know.

B. Peter Mangurian

1. Sales to Peter Mangurian

An agreement entitled "Participation Agreement Craig Muncaster #1" ("Agreement for CM #1") was agreed to accepted on December 12, 2004 by Mangurian. (*See* S-45) The agreement is also accepted by Stout, President of ROG, on behalf of ROG. (*Id.*) The Agreement for CM #1 indicates that Mangurian is from California, but also identifies ROG is situated in and operating from Arizona. (*See* S-45 @ ACC001338) According to the terms of the Agreement for CM #1, "It is contemplated that the aggregate of all Participants shall acquire up to an undivided 75% working interest in the well. The proposed operator and/or affiliates will acquire the remaining 25% working interest." (*See* S-45@ ACC001335). The Agreement for CM#1 assigns Mangurian a 1.333% working interest in an oil/gas well for $20,000. (*See* S-45@ ACC001335, ACC001338 and S-46). The Agreement for CM #1 also makes clear that management of the investment is by a majority of the 100% working interest. (*See* S-45@ ACC0013386).

Mangurian was only assigned 1.333 working interest, making clear that he had no real role in managing the investment. Bank records indicate that the check written out to ROG for $20,000 was processed on December 20, 2004, which is just after the agreement was accepted. (*See* S-46

and S-45) This Agreement for CM #1 is an investment in the same oil and gas securities discussed previouisly. (*See* Section II. A.). This investment was not paid back.

Mangurian also made another payment of $20,000 on June 22, 2005 in ROG. (*See* S- 49) According to the business records of Wells Fargo, that check was processed on July 6, 2005. (*Id.*) This payment to ROG was apparently refunded to Mangurian for his investment in MC #4 as indicated in the memo section of the check. (*See* R-4). The Division does not contest that Mangurian's second investment was refunded.

2. **Fraud in connection with the Sale to Peter Mangurian**

Mangurian was sold oil and gas securities by ROG. Correspondence between ROG and REO Energy, Ltd., ("REO") confirms that $14,664.00 of Mangurian's funds were placed by ROG in a test well of REO. (*See* S- 37 and S-48). In a letter to REO, Stout states, "Thank you again for letting Mr. Mangurian place his money with you in the Craig Muncaster #1… Enclosed is a check in the amount of $14,664.00 for a 1.333% (0.13333) working interest…" (*See* S-48). Curiously, REO's letter to Stout shows that the 1.333% working interest in Craig Muncaster #1 is submitted to ROG, not Mangurian. (*See* S-47).

There is no explanation of where the approximately $5,400 remaining from Mangurian's funds were spent. There also was no disclosure of a commission for that amount to Mangurian. (*See* S-45). *Stone v. Kirk,* 8F.3d 1079 (6th Cir. 1993) (Eighteen percent commissions are a highly material fact whose nondisclosure violates Securities laws.). Furthermore, Mangurian's agreement with ROG states "*Specializing In Low Risk Opportunities*" at the footer of each page. (*See* S-45). In contrast, the letter from REO to ROG concerning the same project states that it, "is a very high risk undertaking and all of your investment (including your contribution for completion expenses) may very likely be lost or else never recovered in its entirety…" *(See* S-47 @ ACC001809). This conduct on the part of Stout and ROG relates to the sale of a security to Mangurian and is patent fraud. A.R.S. § 44-1991.

C. Sale to Gloria Langley

Gloria Langley (Langley) invested $10,000 with ROG. (*See* S-50). A check from Langley is written out to ROG and is dated June 4, 2005. (*Id.*) Although there was no participation agreement admitted into evidence concerning this transaction, the check itself references Craig Muncaster #4. In response to questions from Respondents counsel, Smith testified that Langley was Mangurian's girl-friend at the time of the transaction and confirmed that Langley was introduced to ROG through a mutual contact. (*See* S-41 @ 92:1 to 93:11)

This sale is similar enough to other transactions in this case to conclude that this is yet another investment in ROG's oil and gas securities as discussed before. The Respondents indicate that on February 3, 2006, Langley was repaid $11,000.00. This does not nullify the violation of law. The Division does not dispute the repayment was made, after the TC&D issued, but maintains that Langley was sold securities by ROG.

D. Public Offers

1. Internet Offer

A copy of ROG's website at http://www.reserveoil.com (the "website") was printed by Smith on August 24, 2005. (*See* S-41 @ 27:11 to 17; *See also* S-58 and Hearing Transcript Vol. I @ 191:24 to 192:16) The website also specically states,

> Reserve Oil & Gas, Inc., is seeking participants who demand substantial returns with minimal risk for its off-set drilling project located in Cooke and Wise counties, "hottest gas play in Texas." The program will raise $1,125,000 for a 75% working interest in each well." (*See* S-58 @ page ACCOOOO11).

The website describes the same unregistered oil and gas securities described in Section II. A. above. (*See also* S-2(a)). Although Respondents will undoubtedly point out that disclaimer language at the end of the website which states that the website "is not an offer" (*See* S-58 @ ACC000030), the website clearly indicates that it is seeking investors. Simply stating on the website that it is "not an offer" is not enough. The site clearly is "an attempt or offer to dispose of,

or solicitation of an order or offer to buy, a security or interest in a security for value" pursuant to A.R.S. § 44-1801(13).

The website was accessible through a public computer and was not password protected until after the TC&D issued and therefore it was a public offer of unregistered securities, from at least August 24, 2005, until shortly after the TC&D issued. (*See* S-41 @ 119-22 to 120:16. *See also* Hearing Transcript Vol. I @ 192:23 to 194:02). All internet offers must come within the safe harbor rules promulgated under the Act. (*See* A.A.C. R14-4-142 and A.A.C. R14-4-143). To begin with, ROG's website cannot comply with A.A.C. R12-4-142 because this rule do not apply to securities offers from Arizona. (*Id.)* Here, the website clearly identified that ROG was doing business from Arizona. (*See* S-58 @ ACC000010, ACC0000020, and ACC000029). Furthermore, this rule requires that the internet offer specifically and conspicuously state that "the securities are not being offered to persons in Arizona." (*See* A.A.C. R14-4-142(B)(1)(a)). No such language is contained on ROG's website. (*See* S-58).

The other safe harbor rule at A.A.C. R12-4-143 is inapplicable because it requires the sales activities comply with registration requirements, or that they be exempt from the registration requirements. Respondents did not register and their activities are not exempt. Therefore, any argument made by Respondents claiming that they fall within the protections of the safe harbor provisions must be discarded.

2. <u>Internet Offer and Fraud</u>

The website specifically states:

> **TAX BENEFITS:** 80% immediate deduction of invested amount on intangible drilling and completion costs, tangible asset depreciation, and depletion allowance.

(*See* S-58 @ page ACC000012)

The website does not disclose Stout's tax evasion conviction. (*See* S- 3 and S-58) In view of the tax advice given on the site, the Division argues that a reasonable investor would have wanted to know about Stout's tax evasion conviction. As discussed previously there is no time limit in Arizona by statute or otherwise. Moreover, it is clear that efforts were made in this case to hide Stout's tax conviction.

Bank applications established Stout as the Vice-President of Reserve Oil & Gas, Inc. since January 29, 2001. (*See* S-23 @ page ACC000303 to ACC000304). Nonetheless, the "Certificate of Disclosure" filed in Arizona, dated February 20, 2001 indicates that no person elected as an officer, director, or who is control person of ROG has "been convicted of a felony" relating to fraud, within 7 years preceding the filing. (*See* S-1(a)). Stout's crime concerned fraud. "Any person who willfully attempts in any manner to evade or defeat any tax imposed ... shall be guilty of a felony ..." 26 U.S.C. § 7201. As of January of 2001, Stout's tax evasion conviction was just about 4 years prior to the filing of the "Certificate of Disclosure." Any person attempting to do due diligence on the company by searching corporate records was intentionally mislead.

Additionally, the website specifically states, "Reserve Oil & Gas, Incorporated has wide experience in oil and gas production and management. Reserve has entered into an agreement with Benco/Rife operating, to help develop their six thousand plus acres. Under the agreement, Reserve will raise $1,125,000 per well for a 75% working interest." (*See* S-58 @ page ACC000010).

At hearing Mr. Thomsen testified as follows:

Q. In your review of the file, Mr. Thomsen, have you come across any agreement between Reserve Oil & Gas and Benco/Rife Operating?

A. No.

Q. And have you reviewed the entire file?

A. Yes, I have.

Q. Have you reviewed all the documents produced pursuant to subpoena by Mr. Burton Bentley?

A. Yes.

Q. And have you reviewed all the documents produced pursuant to subpoena by Mr. -- by Reserve Oil & Gas' current attorney?

A. Yes.

Q. And upon review there is no agreement found with Benco/Rife?

A. No.

Q. Okay. Or let me ask the question again. There is no agreement with Benco/Rife and Reserve Oil to develop 6,000 acres, is that correct?

A. Correct.

(*See* Hearing Transcript Vol. II @ 205:14 to 206:8)

The Administrative Law Judge gave ROG an opportunity to provide evidence of such an agreement (*See* Hearing Transcript Vol. II @ 206:19 to 207:8); but ROG failed because none existed. Therefore, ROG's statements about the agreement are false, they were made in connection with the sale of a security which violates A.R.S. § 44-1991.

E. Potential Arizona Investor

1. Actual Offer

After reviewing and printing a copy of ROG's website, Investigator Smith posed as Freemire and communicated with Respondents via e-mail, by telephone, and then met with Stout and Allen L. in person. (*See* S-41 @ 27:18 to 30:15; See also S-58, S-59, S-31(a), S-31(b) and S-36(c)). The phone conversation and meeting in person was recorded. (*See* also S-31(a), S-31(b) and S-36(c)). At the hearing, portions of the recording of the meeting in person with Smith were read. (*See* Hearing Transcript Vol. II @ 244:25 to 248:23).

At the meeting Smith received a brochure about ROG's program. (*See* S-37 and Hearing Transcript Vol. II @ 249:15 to 250:25). All of the information received by Smith through the website, via e-mail, telephone, and in person re-affirms that ROG's oil and gas program were publicly offered securities as discussed and analyzed previously. (*See* S-58, S-59, S-31(a), S-31(b), S-36(c), S-37). Smith posing as Freemire ("Smith/Freemire") was unknown to Respondents; he had no pre-existing relationship with them. Although Respondents did require Smith/Freemire to complete a purchaser questionnaire and he submitted it, the completed form did not qualify him as an accredited investor. (*See* S-59 @ ACC001591 to ACC001594).

Nonetheless, Respondents did not reject Smith/Freemire as an investor. (*See* Transcript of proceedings Vol. II @ 242:9 to 243:2). Clearly, they provided him with ample information and met with him to discuss the program. All of these exchanges with Smith/Freemire constitute an actual offer of securities in ROG in violation of A.R.S. § 44-1841.

2. Actual Fraud

During the meeting Smith had in person with Respondents on September 25, 2005, the follow statements were made by Allen C. Stout ("Stout"):

> "And in a well, I (indiscernible) there's three risks. You have a drilling risk, you have a completion

risk, and you have a geological risk. Geological risk is, of course, what we have eliminated, because the Barnett Shale is, uh, the geologists told me that -- I was walking out there, and he said, quote, **'Allen, a blind man can walk on this lease and say, 'drill here,' and you are going to make a well.' That's what, all it takes. I mean you just got to drill."** (emphasis added).

(*See* Hearing Transcript Vol. II @ 247:23 to 248:6; S-36(c) @33:20 to 34:3).

Also, at the meeting in person with Smith the following exchange took place between Stout and Smith:

"Investigator Smith: So now how are you guys tied with Benco? I mean –

"Mr. Stout: I have an agreement with them.

"Investigator Smith: Just an agreement?

"Mr. Stout: Um-hmm. I have an agreement with them to work, and then I, I get, when I do, well, I get 2 percent over any royalty in the well.

"Investigator Smith: Is it –

"Mr. Smith: It's not out of, it's not out of the working interest or anything else. It's not out of your portion of it. It's out of a different part, the royalty part of it."

(*See* S-36(c) @18:19 to 19:5).

Both of the above excerpts emphasize the frauds that have been discussed previously. In the first referenced statements, although Stout is attempting to discuss risks, he manages to say that there is **no geological risk** in the program. This representation cannot be and is not true. In the second exchange, Stout continues to tout the agreement with Benco which does not exist! He

also goes on to state that he makes money from royalties and not from the working interest. This is contrary to the approximate $5,400 that were not invested on behalf of Mangurian. Both of these instances are examples of frauds that occurred in connection with the offer to Smith/Freemire.

3. **Fraud by Allen L.**

Among all the communications had with Smith/Freemire, in writing and in person, all of which are memorialized in writing or are recorded, there is no disclosure to him of Stout's tax evasion conviction. (*See* S-41 @ 27:18 to 30:15; See also S-58, S-59, S-31(a), S-31(b) and S-36(c)). Smith testified that neither Stout nor Allen L. informed him when he met them that Stout had a tax evasion conviction. (*See* S-41 @ 11: 12 to 11:18). At the meeting in person, Stout discussed with Smith/Freemire the tax consequences of the investment in ROG in the presence of Allen L. (*See* S-36(c)). At the meeting, Stout identified his son Allen L. as the Vice-President of the company.[7] (*See* S-36(c) @ 43:12 to 43:18). Allen L. failed to disclose to Smith/Freemire the tax evasion conviction of Stout. This omission constitutes fraud pursuant to A.R.S. § 44-1991.

F. Sale to Ingell and Fraud

Testimony was heard at the hearing concerning Scott Ingell ("Ingell"). Also, documents were admitted into evidence memorializing the transactions Ingell had with ROG. (*See* S-51, S-56, S-57). Ingell testified that he invested $135,000 with ROG and that the money was written out of his account. (*See* Hearing Transcript Vol. 1 @ 120:16 to 121:16). He mailed the check to Phoenix, Arizona. (*See* Hearing Transcript Vol. 1 @ 122:8 to 122:12). The check to ROG identifies a check written on the account of Scott and Amy Ingell on December 29, 2005. (*See* S-57). Ingell also identified that he received correspondence concerning his transaction with ROG dated December 29, 2005. (*See* Hearing Transcript Vol. 1 @ 127:24 to 128: 4). Admitted at the hearing was a letter to Ingell from ROG dated December 29, 2005. (*See* S-56). That letter

[7] Allen L. also appears as the President of ROG on records submitted to and maintained by the Arizona Corporation Commission. *See* S-1(a).

proposed a test well with ROG in the same oil and gas securities that have been discussed previously in this memorandum. (Id.) Additionally the letter explained that in exchange for $135,000 Ingell would receive an 8.0% working interest in Phillips #2. (Id.) This transaction constitutes a sale of an unregistered security to Ingell.

Ingell testified that he received an "Authority for Expenditure" from ROG. (*See* S-51) that he identified on the record, and received after his investment. (*See* Hearing Transcript Vol. 1 @ 122:16 to 123:14, 124:6 to 124:14, 143: 7 to 143:18). The "Authority For Expenditure" received by Ingell shows a total project cost of $135,200. (*See* S-51). According to his testimony, it was Mr. Ingell's understanding and expectation that the full amount of his investment would be spent on an oil well and that the proceeds would be used as explained on the Authority for Expenditure he received. (*See* Hearing Transcript Vol. 1 @ 128:23 to 129:5).

However, also admitted at the hearing was evidence that only $108,000 of Ingell's money was put in an oil well and not his entire $135,000. investment. (*See* S-53, S-54, and S-55). In particular an Authority for Expenditure marked S-52 (aka SD-11) was received directly from REO. (See Hearing Transcript Vol.II @271:20 to 272:16). The Authority for Expenditure from REO concerned the same well that Ingell was placed in by ROG. (*Compare* S-51 with S-52) For example, both documents are dated October 25, 2005, both referenced the same well – Phillips 2, and both indicate AFE NO: 155 on the top of the first page. Additionally, both documents are for an 8.0% non-operator's interest and state "St. Jo" as the "Prospect."(*Compare* S-51 with S-52; *See also* transcript of the proceedings Vol. II 271:21 to 272:16 and @ 287:3 to 288:18; *See also*, S-41 @ 22:2 to 23:14).

The Authority for Expenditure from REO showed that indeed only $108, 000.00 had been invested in Phillips #2 for a 8.0% working interest in the well. However, the Authority for expenditure provided to Ingell represented that expenditures in the amount of $135,200 had been made for the same interest in the same well. If ROG had simply wanted to sell the 8.0% interest

they had in Philips #2 with REO (See S-53, S-54, and S-52), they could have done so by disclosing their commission on the sale to Ingell. Instead of disclosing their 20% commission, Stout and ROG undertook to provide Ingell with an Authority for Expenditure that contained false information so that it appeared to cost $135,200 to drill the well. (*Compare* S-51 (provided by ROG to Ingell) with S-52 (provided by REO). *Stone v. Kirk*, 8 F.3d 1079 (6th Cir. 1993) (Eighteen percent commissions are a highly material fact whose nondisclosure violates Securities laws). When ROG presented Ingell with the Authority for Expenditure marked as S-51 they provided him with false information concerning his interest in the oil and gas securities. This conduct constitutes fraud in violation of A.R.S. § 44-1991.

Finally, at the hearing, Respondents through counsel stipulated that Ingell's $135,000 had not been paid back. (See Transcript of the Proceedings Vol. III @ 433:10 to 433:16).

IV.

CONCLUSION

The evidence adduced at hearing includes the following:

A. Public offers in ROG's unregistered securities via the internet from August 24, 2005 to at least December 30, 2005;

B. At least four sales of unregistered securities from Arizona to investors;

C. An offer to purchase securities from Arizona for an investor as an unregistered salesman;

D. An offer in ROG's unregistered securities via a promissory note;

E. An offer to a potential Arizona investor; and

F. Various frauds in connection with the securities sales and offers, to include the omission by Allen L.;

Based upon the evidence admitted, the Division respectfully requests this tribunal:

1. Order Respondents Stout and ROG pay restitution pursuant to A.R.S. § 44-2032(1), in the amount of $155,000.00;

2. Order all the Respondents to pay an administrative penalty of not more than five thousand dollars ($5,000) for each violation of the Act, as the Court deems just and proper, pursuant to A.R.S. § 44-2036(A); The Division recommends a conservative penalty of no less than $50,000 for Stout and ROG jointly. The Division also requests a penalty of no less than $5,000 for Allen L.;

3. Order Respondents cease and desist from further violations of the Act pursuant to A.R.S. § 44-2032.

4. Order any other relief this tribunal deems appropriate or just.

Dated this 26th day of September, 2007.

By Shoshana O. Epstein, Esq.
for the Securities Division

ORIGINAL AND THIRTEEN (13) COPIES of the foregoing filed this 26th day of Setember 2007, with

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